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August 12, 1997

Multistate Tax Commission
Attn: Paull Mines, General Counsel
444 Capitol Street, N.W.
Suite 425
Washington, D.C. 20001

Re: Comments on the Initial Public Participation Working Group Draft of the
Constitutional Nexus Guideline for Application of a State's Sales and Use Tax to
an Out-of-State Business (the "Guideline")

Dear Paull:

Enclosed are black lined revisions to lines 1-105 of the Guideline and my comments on those revisions and other sections of the Guideline, pretty much on a section by section basis.

This is my own effort, done without consultation with anyone else. It is fairly rough. I have not reviewed cases (except for a read through Quill); I have followed the structure you established rather than creating something new; and I have not attempted to edit or polish my own work.

Your draft is powerful and comprehensive. I am inclined to think that it is a bit too much of each, but my hat is off to your intellect, your command of the issues, and your energy for this work.

I take as givens that the draft was intended to at least facilitate creation of a position of maximum state power, that that may differ from a state perspective on what would be a "more likely than not" position; and that both will be far stronger for the states than their counterparts on the business side. In other words, there will be no consensus on certain key points. Nevertheless, I believe that there can be consensus in shaping issues for consideration by businesses, tax administrators, the two together, and the courts, and great potential utility in doing that and communicating the MTC's views to taxpayers and tax administrators.

**Deloitte Touche
Tohmatsu
International**

I have tried to bridge the rather considerable gap between lawyers' love for linguistic abstraction, which is in full bloom on state tax constitutional issues, and what I believe to be some fairly straight forward, practical issues for both tax administrators and businesses in the sales and use tax nexus arena. In addition to the attached comments on a section by section basis, I have the following Top 10 list of suggestions.

1. **Disclose both a maximum and a more likely than not position.** I suggest that the MTC develop both the position that it considers the maximum reasonable exercise of State power and a position that it believes to be more likely than not to be sustained if challenged. This would apply only to a handful of key pressure points.

I make this recommendation because it appears likely to me that the MTC's version of the maximum reasonable exercise of State power is likely to be so far from the views of informed business people as to make the Guideline lose much of its potential usefulness. The great practical hope from the tax administrator side, I believe, is to persuade thousands of businesses to get on the wagon. That persuasion is much more likely to be effective if the business community sees the MTC espousing positions that appear to business people to be credible, and provide some reasonable qualitative and quantitative indicators of nexus thresholds. By espousing a maximum State power position that lacks credibility in the business community, the MTC will encourage thousands of businesses to play as dumb as they can for as long as they can on sales and use tax nexus. The MTC badly needs to find a way to promulgate quantitative and qualitative nexus indicators that are viewed as reasonable in the business community.

2. **Consider amnesty and penalty differentials.** Once satisfied that it has articulated a position for the states that will have some degree of credibility in the business community, the MTC might also consider recommending and then loudly promoting both an amnesty program for a period of time and penalty differentials on an ongoing basis for businesses that come forward voluntarily. Such a program could cause more businesses to take the trouble to check out their nexus exposure rather than continuing either to play dumb, or actually to be ignorant. (Lean business tax departments sometimes have a hard time complying with the state reporting obligations they know they have, much less speculating on whether there are still more out there).
3. **Restrict the Guideline to the use tax collection issue.** Such restriction is adverted to at various points in my comments. I reiterate it here. Focusing on the use tax collection issue would facilitate simplification of the Guideline and its effectiveness as a training and communication tool for states and businesses. Restricting the Guideline to the use tax collection issue would much improve its potential for providing guidance and influencing conduct. Bringing in the purchase side liability of out-of-state businesses as purchasers adds conceptual complexity that makes it

more difficult to focus on everyone's main concern: when it is that a business exploiting a State's market from outside the State must collect the use tax. Moreover, there generally will be a lot less interest on the part of the states in purchaser nexus (generally a one transaction at a time proposition), and the facts and circumstances in those situations generally will be so different from the sale side situations that there seems little point in trying to combine them. Finally, I doubt whether anyone is really focused on the purchaser side. If I have passed over a major issue on the purchaser side, the solution is to promulgate a separate purchaser side guideline, not try to handle both together.

4. **Reconsider the Guideline once the DMA agreement terms are set and accepted on each side.** The apparently forthcoming successful conclusion to the DMA negotiations is a major event in this field that is to be applauded. The substance as outlined at the annual meeting certainly seems reasonable from what I know of both the tax administration and business perspectives. But I find it hard to believe that a thoughtful tax administrator who could sign that agreement could also take seriously the type of maximum state power position the draft Guideline indicates is worthy of serious consideration.
5. **Do not engage in fictions in the Guideline.** The draft Guideline clearly contemplates the possibility of fictional claims of physical presence by out-of-state businesses. I believe that that approach will infuriate businesses, utterly fail to communicate a credible nexus position to the thousands of businesses that still either play dumb or are genuinely ignorant on nexus, and not impress a Supreme Court that at least thinks it has abandoned highly formalistic notions to deal with economic reality in the state tax arena. Quill did not establish a bright line on physical presence (look at the catalogs, the software and the goods themselves.) It established a bright line on human presence to perform solicitation of sales.
6. **Deal with electronic commerce.** There are a number of places in the draft Guideline where sections are reserved to deal with issues in the electronic commerce arena. I strongly urge you to deal with them.
7. **Differentiate between contacts related to soliciting sales and other contacts.** The courts presumably will look at the totality of facts and circumstances in making nexus determinations. I would suggest that physical presence in the State on the sales side (prior to but not after sale) should be more of a factor than exceedingly minor contact with the State in some other context, but that having a substantial facility in the State unrelated to the sales side must also suffice under National Geographic. Taking an approach such as this would recognize the reality that tax departments of businesses are in no position to know what every contact with each state is. It is not too much to expect use tax collection to be taken into account when planning the sales effort

(though it probably frequently does not happen). It is totally unreasonable to expect it to be taken into account with respect to other relatively minor contacts with a State, and very high handed to retroactively demand, as a result of such contacts, payment of tax that was, in good faith, never collected, plus interest and penalties.

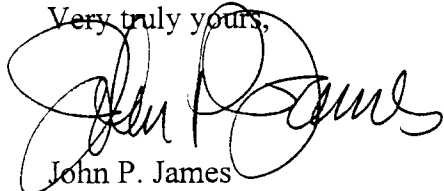
8. **Look to the totality of contacts, physical and nonphysical, and assert what you believe is the required physical contact threshold that must be included.** I took a stab at this in editing the "de minimis" concept. This may be the only area in which serious conflict between the states and business is inevitable. We should work together to end up with a Guideline that facilitates rational administrative and judicial consideration of the conflict in particular cases. Quill requires some degree of physical presence. The MTC should make perfectly clear in this Guideline what it believes the scope of Quill to be and why, as to both the quantum of presence and the scope of economic nexus without meaningful physical presence if that is what it believes the Constitution allows.
9. **Differentiate between two separate state goals in the use tax collection arena: compliance with clearly constitutional nexus standards and movement toward economic nexus without physical presence.** If the final Guideline fulfills the promise inherent in the draft, the MTC will be emphasizing movement toward economic nexus without physical presence. The emphasis, however, will necessarily be in the courts, because business is not going to buy it after Quill. The states may or may not eventually win that war if you choose to fight it. I personally think the odds are strongly against you, as the Supreme Court has rather clearly invited Congress to deal with this. By choosing war in the courts, I believe that the MTC would greatly diminish the states' ability to get more businesses to comply with nexus standards that many, if not all, of the participants in the PPWG would concede to be constitutional.
10. **Think big with industry about major reform of multistate taxation.** If economic nexus without physical presence is what you think you need, I think you will have to seek it in Congress. But I would not suggest asking Congress for that per se, as that would just shift the war from the courts to the Congress.

I do suggest continued dialogue with industry about what might be mutually workable at minimal administrative cost. From the business perspective, dealing separately with thousands of jurisdictions is costly if not absurd. From many states' perspective, business must deal with those jurisdictions because of statutory or constitutional provisions that no tax administrator can get changed for the convenience of business. Neither side really trusts Congress to automatically do the right thing. The odds of that happening probably would be better for both sides if they could work something reasonable out.

At the annual meeting, Wade Anderson, Jim Eads and Dan Bucks presented some interesting ideas. If there were a no sacred cows effort to rationalize state taxation for the 21st century, some spectacular progress could be made, leading to a much less administratively costly tax system, with plenty of flexibility for state and local governments at the margin.

With the changes in electronic commerce, telecommunications and electric utility deregulation, a revolution in state taxation is going to be required. My advice to the MTC is to foment it by pushing the dialogue with business that has progressed so spectacularly in the last few years forward to the redesign of state taxation of multistate and multinational businesses. Many of the players are already at the table. But the conversation needs to be about what the new system should be, not over the assertion within the current system of fictional or exceedingly minimal physical contacts between businesses and states as warranting the elimination of an exemption from use tax collection responsibility that businesses reasonably believe has been granted by the United States Constitution and blessed by the United States Supreme Court.

Very truly yours,

A handwritten signature in dark ink, appearing to read "John P. James", written over the typed name.

John P. James
Partner Multistate Tax Services

cc: Dan Bucks
Merle Buff
Kaye Caldwell
Kendall Houghton

JPJ:sg